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No. 99-2047

In The

Supreme Court of the United States

ANTHONY PALAZZOLO,

Petitioner,

v.

THE STATE OF RHODE ISLAND *EX REL.* PAUL J. TAVARES, GENERAL TREASURER, AND COASTAL RESOURCES MANAGEMENT COUNCIL,

Respondents.

On Writ Of Certiorari To The Supreme Court Of Rhode Island

BRIEF AMICUS CURIAE OF DANIEL W. BROMLEY, DAVID E. ERVIN, BARRY GOODWIN, RAY HUFFAKER, AND C. FORD RUNGE IN SUPPORT OF RESPONDENTS STATE OF RHODE ISLAND *ET AL.*

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The economists listed in the appendix, all of whom teach and conduct research in the field of economics and related disciplines, submit this brief amicus curiae in support of the respondent State of Rhode Island.[1]

The first purpose of this brief is to use standard economic theory and principles to analyze the two issues of substantive takings law raised by this case, the validity of the "notice rule" and the scope of the regulatory takings doctrine. This analysis points to several persuasive reasons for the Court to reaffirm the notice rule and for the Court to rely on that rule in this case to deny the petitioner the taxpayer-funded recovery he seeks. This analysis also suggests that, from the perspective of economic theory, the petitioner's entitlement to financial compensation cannot reasonably be assessed without considering the full range of positive and negative effects on the property's value due to different government regulations and other actions. This approach provides a useful framework for assessing the ultimate "fairness" of the Court's traditional view that a claimant must demonstrate denial of all economically beneficial use to establish a taking.

The second purpose of this brief is to respond to the proposition, articulated by some advocates of a broad reading of the Takings Clause, that an expansive rule of takings liability would tend to maximize social welfare in

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[1] Counsel for the parties have consented to the filing of this brief. No counsel for a party in this case authored this brief in whole or in part, and no person or entity, other than amici or their counsel, made a monetary contribution to the brief's preparation or submission. *See* Rule 37.

economic terms. This proposition is based on incomplete and unpersuasive reasoning. In fact, as we demonstrate below, an expansive reading of the Takings Clause might well reduce social welfare in economic terms.

SUMMARY OF ARGUMENT

Under the "notice rule," an investor who purchases property with actual advance notice of a regulatory restriction is barred from subsequently seeking compensation under the Takings Clause based on the restriction's application. This rule bars an investor who may have purchased property at a discounted price based on the effect of the regulation from obtaining a windfall at taxpayer expense. The rule also prevents investors from engaging in strategic rearrangements of property interests in order to maximize their chances of receiving a financial recovery under the Takings Clause; this strategic behavior would produce deadweight economic losses and permit investors to eviscerate the current limitations on the scope of regulatory takings doctrine. In addition, the notice rule achieves a reasonable and necessary balance between protecting the security of private investments and maintaining a property rights system that reflects society's contemporary values and needs.

Second, the standard for a regulatory taking based on a regulation's economic impact cannot properly be determined without an accurate accounting of how government action actually affects property value. A seemingly large "drop" in value based on a comparison of the value

of property subject to regulation and in an unregulated state gives an inaccurate and misleading picture from an economic standpoint. Market prices are an inappropriate benchmark for takings analysis when those prices do not fully capture the true costs and benefits of property being regulated, such as any flood control and water quality filtering functions of wetlands. In addition, a full and fair accounting of the effects of government on property values requires consideration of governmental "givings" as well as regulation's reciprocal burdens and benefits.

Third, some advocates of a broad interpretation of the Takings Clause contend that expansive government liability for regulatory actions under the Takings Clause would tend to maximize social welfare in economic terms. Upon analysis, this argument is unpersuasive. In fact, expansive takings liability may well reduce social welfare in economic terms. Government does not function in the same fashion as a private firm and therefore extensive assessments of financial liability would not influence behavior of government in the same fashion as it would that of a private firm. In addition, to the extent broad internalization of regulatory "costs" would affect government behavior, it would probably encourage officials to discount the benefits of government action relative to its costs. This, in turn, could lead to government decision-making that fails to maximize total social welfare. Also, a broad interpretation of the Takings Clause would likely increase the transaction costs of land use management programs and deter or delay program actions with net benefits for society due to new fiscal demands. Finally, the broad availability of financial compensation would create a form of "moral hazard"

encouraging investors to make overly risky and wasteful investments.

ARGUMENT

I. The "Notice Rule" Prevents Unfair Windfalls at Taxpayer Expense, Avoids Wasteful Strategic Behavior By Investors, and Properly Facilitates Economically Beneficial Change in Property Norms.

One issue in this case is whether an investor who buys with knowledge of the existence of a regulatory program can recover compensation under the Takings Clause if the investor is subsequently subjected to the regulatory restriction. Economic theory points to several independent grounds for upholding the "notice" rule barring recovery in this circumstance.

The first and most basic justification for the notice rule is that the investor may have paid a discounted price for the property based on the existence of the restrictions. *See Loveladies Harbor, Inc. v. United States*, 28 F.3d 1171, 1177 (Fed.Cir. 1994). ("In economic terms, it could be said that the market had already discounted for the restraint, so that a purchaser could not show a loss in his investment attributable to it.") If a purchaser with notice did pay a discounted price, granting compensation based on the property's unrestricted value would, everything else being equal, result in a windfall to the investor at taxpayer expense.

The point can be illustrated using an example based on the case of *Lucas v. South Carolina Coastal Council*, 505

U.S. 1003 (1992). Mr. Lucas purchased two lots for development with the understanding that there were no restrictions prohibiting development. He paid approximately $1,000,000 for the property. A few years later, the State of South Carolina enacted a law prohibiting development of the lots. In that situation, the Court indicated, a taking almost certainly occurred. Consider, however, if the sequence of events were reversed and Mr. Lucas had acquired the property after the regulatory regime was in place. The price Mr. Lucas would have paid for the property would have depended on various factors, such as whether he might have combined the lots with other nearby property and his assessment of the possibility that the regulatory regime might change in the future. But it is fair to assume that Mr. Lucas would have paid significantly less than $1,000,000 for the property. Under this hypothetical scenario, if he then sued for a taking demanding "just compensation" should the law compel the taxpayers to pay him $1,000,000? Just as Mr. Lucas, based on the facts of the actual case, presented a compelling case of economic injury, so too Mr. Lucas, in this hypothetical example, would be seeking a simple windfall.[2]

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[2] More generally, a decision by this Court to reject the "notice rule" would result in a massive, one-time transfer of wealth from the general public to property owners. Given that, according to our understanding, the majority of jurisdictions follows the notice rule, investors have undoubtedly factored their lack of investment-backed expectations into their estimates of their financial standing. Repudiation of the notice rule would confer a windfall on those investors who acquired hazardous and environmentally sensitive lands and who harbored little or no expectation of being able to make

The primary counter-argument, as articulated by several of petitioner's amici, is that the notice rule should be rejected, not to protect any legitimate entitlement of the purchaser herself, but to protect the expectations of the seller. According to this view, as a result of the notice rule, the owner of property subject to a new regulatory restriction would lose value because any prospective purchaser would be barred from pursuing a taking claim and, therefore, would only be willing to pay the seller a discounted price. As a result, a seller who acquired the property without advance notice of the regulatory restrictions would suffer an unanticipated (and unfair) financial loss. The notice rule should be rejected, the argument proceeds, in order to support the value of the property in the hands of the seller and thereby protect him from this loss.

This counter-argument cannot carry the day. Even if the property's value for sale is reduced, the owner can continue the property in its current use or seek to develop it herself. *See Andrus v. Allard*, 444 U.S. 51 (1979) (holding that complete abrogation of the right to sell did not effect a taking, given the other potential uses available to the owner). Moreover, it is debatable whether this type of loss in value upon sale is even the kind of effect on property covered by the Takings Clause. In *Eastern Enterprises v. Apfel*, 524 U.S. 498 (1998), Justice Kennedy, concurring in the judgment and dissenting in part,

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maximum development use of the property. Repudiation of the notice rule also would encourage owners to advance large, potentially hazardous or environmentally destructive projects in order to prompt payments from the government.

observed that a regulation which causes financial loss, but which does "not operate upon or alter an identified property interest," cannot effect a taking of property with the meaning of the Takings Clause. *See also Id.* at 554 (Brever, J., dissenting). A reduction in a property's sales price seems more akin to the financial liability at issue in *Eastern Enterprises* than to an actual restriction on the use of property.

In addition, the seller's ostensible "loss" upon sale of the property following new regulatory restrictions would likely be highly speculative and difficult to quantify. If the alleged loss were based on the possibility that a development permit would be denied, but there also were the possibility that development approval would be granted, the impact of the adoption of the new restriction on the property's sales price might be modest.

The second economic argument for why a purchaser with notice of regulation should be barred from recovery under the Takings Clause is that this rule prevents strategic behavior by owners who, in the absence of the notice rule, would have a strong incentive to rearrange their property interests in order to maximize the chances of a financial recovery from the public. In practice, it would be impossible for the courts to differentiate between bona fide takings claims and those which are the result of strategic behavior. This strategic behavior would seriously undermine if not demolish existing limitations on the scope of recovery under the Takings Clause.

Again, the problem can be illustrated by an example. If a hypothetical Mr. Lucas owned a 200 acre parcel in

South Carolina, and two acres of the property were subject to the new prohibitions on coastal development, Lucas could, in the absence of the notice rule, manufacture a taking claim simply by selling off the restricted two acres. The purchaser, armed with the precedent of *Lucas* itself, and not impeded by his actual notice of the restrictions on development, would presumably have a meritorious takings claim. Thus, despite the fact that the hypothetical Mr. Lucas would lack a meritorious taking claim himself, he could easily manufacture one – and receive the economic benefit of such a claim – by rearranging his property interests in light of the new restriction.

Similarly, this Court's ruling in *Penn Central Transp. Co. v. City of New York*, 438 U.S. 104 (1978), could easily be eviscerated if the Court did not continue to uphold the notice rule. In that case, the Court ruled that a prohibition against the development of the air space atop historic Grand Central terminal did not effect a taking given the company's opportunity to continue to use the site as a terminal. However, in the absence of the notice rule, the company could simply bypass the Court's ruling by selling the air rights to some newly established corporation which could then sue on the ground that the law eliminates all of the air rights' economically beneficial use.

The point, which could be supported by innumerable examples, is simply that the opportunity to reconfigure property interests knowing how regulatory restrictions affect a particular property would create essentially unlimited opportunities to manufacture takings claims that otherwise would not exist.

The strategic behavior that would be encouraged by elimination of the notice rule would have no economically productive value. Thus, the significant transaction costs entailed in these strategic rearrangements of property interests would produce a so-called "dead weight" economic loss. *See* Robin Boadway & Neil Bruce, Welfare Economics 240-41, 208-09 (1984).

Significantly, an owner's advance knowledge of a regulation that effects a *physical occupation* of property does not create the same incentive to engage in strategic behavior as does advance notice of a regulatory *use* restriction. This important consideration distinguishes *Nollan v. California Coastal Commission*, 483 U.S. 825 (1987), which involved an alleged physical occupation, from this case, which involves a restriction on use. In *Nollan*, of course, the Court indicated that a purchaser's advance notice that the government would impose a physical taking should not bar a taking challenge to this type of imposition.

Under the Court's decision in *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982), a regulation either effects a physical occupation or it does not based on the character of the regulation, regardless of the economic impact of the regulation or the proportion of the property affected by the physical intrusion. As a result, in a case involving an alleged physical occupation, in contrast to a case involving a use restriction, advance notice does not create an incentive to engage in strategic behavior in order to manufacture a takings claim. This distinction provides a logical basis for treating the fact that a purchaser had notice of a regulation differently depending upon whether the regulation involves a physical

occupation or a use restriction. Contrary to the views of petitioner and his amici, the Court's ruling in *Nollan* cannot automatically be extended to a case involving a use restriction.[3]

Finally, the notice rule is based on the law's logical use of the event of a sale to achieve a rough balance between, on the one hand, the social value of a property regime that conforms to contemporary circumstances and values and, on the other, the social value of stable expectations about the permitted uses of property. Change is, of course, endemic to property law. As the Court recently affirmed, "the property owner necessarily expects the uses of his property to be restricted, from time to time, by various measures newly enacted by the State in legitimate exercise of its police powers." *Lucas*, 505 U.S. at 1027. Social welfare would suffer if the Takings Clause were interpreted as impeding necessary evolution in property norms by requiring the public to indemnify any owner

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[3] To be sure, this incentive for strategic behavior could also be dealt with by equating regulatory use restrictions with physical takings and requiring the taxpayers to pay for every regulatory burden no matter how minute, as suggested in the brief of petitioner's amicus Institute for Justice, authored by Professor Richard Epstein. Suffice it to say that this radical reinterpretation of the Takings Clause has no support in either the original understanding of the Takings Clause or any of the decisions of this Court. *Cf.* Robert Bork, *The Tempting of America: The Political Seduction of the Law* 230 (1990) ("My difficulty is not that Epstein's constitution would repeal much of the New Deal and the modern welfare-regulatory state but rather that these conclusions are not plausibly related to the original understanding of the takings clause.")

burdened by social change. On the other hand, dependable expectations about the permitted uses of property, and hence the value of particular investments, fosters more investment and provides a benefit to society as a whole. From an economist's standpoint, the issue is how to balance these competing considerations.

Providing a significant degree of protection to owners' established investment expectations, but requiring purchasers with notice to conform to new property norms, achieves an appropriate economic balance between necessary legal change and stable incentives for investment. The notice rule ensures that an owner's original investment expectations are entitled to attention and respect. On the other hand, the notice rule facilitates useful social change by imposing the responsibility for dealing with new legal norms upon owners who purchased their properties with conscious understanding of the restrictions created by these new norms.

The issue of when compensation should be available under the Takings Clause during a period of legal change is related to what law and economics scholars refer to as the problem of legal "transition" policy. *See, e.g.*, Louis Kaplow, "An Economic Analysis of Legal Transitions," 99 Harv. L. Rev. 509 (1986). This scholarship poses the question of whether the risk of change in public policy should be treated the same as or differently from other kinds of risks that can affect the value of private investments. Economic efficiency will generally be maximized if risk management is left to the operation of the market, which includes adequate opportunities for private insurance programs to develop and creates useful incentives for investors to anticipate potential changes in legal rules

and adjust their plans accordingly. Because the risks of changes in the law are fundamentally the same as other kinds of business risks, the argument continues, these risks too should generally be left to the marketplace. "To the extent that a given transition policy mitigates the impact of a future reform on preexisting investment, those currently making investments will not have the proper incentive to take into account the prospects of future reform." *Id.* at 615. Accordingly, "government compensation or other transitional relief usually is inefficient." *Id.* at 615-16. *See also* Saul Levmore, "Changes, Anticipations, and Reparations," 99 *Colum. L. Rev.* 1657, 1677 (1999) (arguing that an anticipation-oriented theory of takings law provides an "elegant" explanation for the Court's differing treatment of physical occupations, which are generally difficult for owners to anticipate, and changes in regulations, which owners generally can usefully anticipate).

II. A Comprehensive Understanding of How Government Action Affects Property Values Supports the Basic Fairness of the Requirement That a Taking Claimant Demonstrate the Elimination of All Economically Beneficial Use.

A second issue raised in this case is whether compensation ought to be available under the Takings Clause when a regulatory restriction eliminates less than all of the economically beneficial use of the property. This issue undoubtedly raises a host of purely legal questions. But economic analysis can provide some insight into why the

courts have generally confined regulatory takings doctrine to "extreme circumstances." *United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121, 126 (1985).

This suit frames the takings claim by pointing to the value the property would have if the government's regulatory policies were lifted as to this property and comparing that value to the value the property presently has subject to the restrictions. According to petitioner, in the absence of the regulation the property would have a value of over $3,000,000, but in its restricted state the property has a market value of approximately $200,000, yielding a "loss" in value of over 90%. This significant apparent decline in value, according to petitioner and his amici, provides powerful support, standing alone, for this takings claim. However, from an economist's perspective, – even assuming the "before" and "after" market values were accurately calculated (an assumption that appears to be false in this case)[4] – this approach to calculating a regulation's economic impact is seriously flawed. Insofar as the size of such a "drop" in value is treated as direct evidence of an owner's entitlement to relief under the Takings Clause, this approach is completely inappropriate.

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[4] In calculating the $3,000,000 figure, petitioner made a variety of optimistic assumptions about the effects of other applicable regulations and the engineering costs of conducting construction work in a coastal marsh. *See* Testimony of Thomas S. Andolfo, Tr. at 678-79. The Rhode Island Supreme Court termed the $3,000,000 figure "speculative" and "unrealistically optimistic." *See* 746 A.2d at 715 & n. 7.

A threshold problem with relying on estimated changes in market value of property to identify compensable takings is that the basic justification for any regulatory program is that prices set by the marketplace do not reflect the true economic value of certain goods and services not effectively supplied or priced by the market. Regulation is a response to the "market failures" that occur in the absence of government regulation. Market failure occurs, according to the standard economic account, because private economic activity generates "externalities" that are not captured by market prices. The very purpose of regulation is to alter the prices that various goods and services would otherwise command in the market. Hence, relying on the market price of property in a hypothetically unregulated state in order to appraise losses due to regulatory action is caught up in a contradiction; the reason for the regulation itself is the failure of the market and the resulting inaccuracy of price signals.

As the Court has stated, "Under our system of government, one of the state's primary ways of preserving the public weal is restricting the uses individuals can make of their property." *Keystone Bituminous Coal Assn. v. DeBenedictis*, 480 U.S. 470, 491 (1987). The Takings Clause presumably cannot be interpreted to constrain every effort by the political branches of government to regulate externalities in order to promote general economic welfare. Accordingly, a simple examination of change in a property's market value as a result of regulation cannot have determinative significance in the takings inquiry.

Furthermore, an examination of the impact of a regulation on one piece of property in isolation ignores the

significantly positive effects that the same regulation can have when it is enforced against neighboring owners. The Court has relied upon this phenomenon of "reciprocity of advantage" to justify rejecting regulatory takings claims in many cases. Zoning laws provide one example of how reciprocity of advantage operates. As the Supreme Court said in *Agins*:

> [land owners subject to a comprehensive zoning scheme] share with other owners the benefits and burdens of the city's exercise of its police power. In assessing the fairness of the zoning ordinances, these benefits must be considered along with any diminution in market value that the [owners] might suffer.

Id. at 262.

The Court also has invoked the concept of "reciprocity" to explain more generally how all property owners benefit from different kinds of regulations. Some regulations may impose economic burdens on some property owners, and other regulations may confer economic benefits on others, but over the long-term a rough "reciprocity of advantage" is secured for all. For example, in *Andrus v. Allard*, 444 U.S. 51 (1979), the takings claim failed in part because the restriction was "a burden borne to secure the advantage of living and doing business in a civilized society." 444 U.S. at 67. *See also Keystone Bituminous Coal*, 480 U.S. at 491 ("While each of us is burdened somewhat by . . . [the] restrictions [on the uses individuals can make of their property], we, in turn, benefit greatly from the restrictions that are placed on others."); *cf. Lucas*, 505 U.S. at 1017-18 (when a regulation eliminates "all economically beneficial use," "it is less realistic to indulge our

usual assumption that the legislature is simply adjusting the benefits and burdens of economic life in a manner that secures an average reciprocity of advantage to everyone concerned.") (internal quotations omitted) (emphasis added).

In economic terms, a regulated property owner can benefit from the application of regulations to his neighbors in several different ways. First, restrictions on the use of neighboring properties can protect the regulated property from neighboring uses that would detract from the value of his property, for example, by causing pollution or flooding, or by undermining the amenity values in the community as a whole. Second, regulatory restrictions can limit the available development opportunities and thereby increase the scarcity, and hence the value, of remaining development opportunities. *See generally*, C. Ford Runge, The Congressional Budget Office's Regulatory Takings and Proposals for Change: One Sided and Uninformed, 7 *Envtl. L. & Prac.* 5 (1999).

From the perspective of economic theory, it would be nonsensical to assess the impact of a regulation on a single property in isolation without considering how the property's value is affected by the application of the regulation to neighboring properties. However, that is precisely what occurs if one attempts to estimate the value of the property simply by asking what the claimant's property, considered in isolation, would be worth if it were not subject to the regulatory restrictions. This estimate gives the owner credit for the value to him of his neighbors' compliance with the regulation and simultaneously gives him the unique benefit of lifting the regulation from his property. This mistaken approach

exaggerates the actual economic impact of a regulation on a claimant's property. As one commentator has put it, "the correct question is not how much the property would be worth if it and it alone were not subject to restrictions; it is how much the property would be worth if the restrictions did not exist and did not apply to anyone." Timothy Searchinger, "Some Key Questions Raised by the Recent Focus in Takings Cases on 'Reduction in Value' " paper presented at Georgetown CLE Conference on Regulatory Takings (1998).

From the record, it is apparent that the reciprocal advantages established by the Rhode Island coastal regulatory program have helped support and enhance the value of petitioner's property. The Coastal Council's consistent, stringent policy against the filling of coastal marshes has succeeded in preserving the environmental values of Winnipaug Pond and other areas along the Rhode Island coast, making them highly desirable areas to live and vacation. As a result, even though petitioner may not destroy wetlands in order to create buildable parcels of land, he can charge high prices for the several lots for which he can apparently receive regulatory approval. Taking into account as well the dozen lots his corporation initially sold off for development, petitioner will earn a highly favorable return on his initial $13,000 investment in this property under any circumstances. Petitioner's financial success is due, at least in significant part, to Rhode Island's coastal program. In demanding yet more income from Rhode Island's taxpayers through a taking claim, petitioner is seeking to unfairly reap both the economic benefits conferred by government regulation and public indemnification for regulation's burdens.

Tellingly, in his original complaint, the petitioner simultaneously complained about *both* the regulatory restrictions on his use of his property and the government's failure to enforce other regulatory restrictions against his neighbors. For example, he alleged that the Town of Westerly caused him economic loss by "its failure to properly regulate the dumping and discharge of sewerage into Winnipaug Pond," and by its "continu[ing] to issue building permits to other abutters along the pond causing more sewerage to be dumped into the pond." Complaint, Paras, 8, 9, dated June 20, 1988. Nothing could more clearly demonstrate, in the context of this very case and with respect to this very location, how government regulations simultaneously benefit and burden a property owner. The petitioner subsequently filed an amended complaint omitting his objections to insufficiently vigorous regulation, choosing instead to focus exclusively on how regulatory restrictions allegedly harm him. The Court should hold petitioner to his first, more balanced description of how different regulations affect his property interests.

In addition to the phenomenon of reciprocity of advantage, governmental "givings" also should be factored into the equation. Public funding of construction of roads, sewers, and other public facilities, agricultural and other subsidies, and other government tax and spending programs contribute significantly to the value of land. A large number of empirical studies have documented the enormous size of these givings; some of these studies are summarized in C. Ford Runge, "The Congressional Budget Office's Regulatory Takings and Proposals for Change: One Sided and Uninformed," 7 *Envtl. L. & Prac.*

5 (1999). In this case, the Court can take judicial notice of the fact that public investments in the interstate highway system, nearby airports, and numerous other public facilities and programs have contributed to the value of this property. Many givings are, of course, paid for by general tax revenues and provide benefits to society as a whole. It is also true, however, that luck and skillful political activity routinely result in the benefits of givings being concentrated on a small number of land owners. There is no reason to believe that land owners are any more likely to be singled out to bear the burdens of regulatory action than they are to be singled out to be the beneficiaries of governmental givings. If anything, as the country's agricultural policies and flood insurance programs suggest, the opposite is more likely to be accurate. The economic fairness of the burdens allegedly imposed by government cannot be accurately appraised without taking into account the givings.

In *Armstrong v. United States*, 360 U.S. 40, 49 (1960), the Court observed that the Takings Clause is designed "to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole." On the one hand, the *Armstrong* "principle" has seemingly undeniable force. On the other hand, it can also be read as a simple tautology which adds little meaning to the language of the Takings Clause itself. Most critically, it begs the question of what, in fact, do "fairness and justice" require? For the reasons discussed, at least from the perspective of economic theory, "fairness and justice" require a full and accurate accounting of how various

public actions actually affect the value of a particular parcel of property.

III. Expansive Liability Under the Takings Clause Could Well Lead To Economically Inefficient Government Decision-Making and Encourage Inefficient Investor Behavior.

Finally, the amici wish to address the argument that some have advanced that an expansive theory of regulatory takings liability would promote economic efficiency. For the reasons described below, the amici submit that this argument is unpersuasive. Indeed, just the opposite result may occur.

A. The Government Deterrence Rationale.

The principal efficiency-based argument for subjecting government to expansive liability under the Takings Clause relies on an analogy to the incentives created for private firms by the tort law system. A private factory may discharge pollutants into a river resulting in harm, for example, to public health or to other businesses such as commercial fisheries. In a competitive economy, a profit-maximizing firm will have little or no incentive to consider these external costs in its internal business accounting. Absent some legal constraint, the factory will continue to pollute despite the fact that this result is not economically optimal for society as a whole. However, according to standard economic theory, if the firm is required to pay monetary damages to those adversely affected by its operations, the firm will be compelled to internalize the external costs. In that event, the firm will

continue to operate its polluting factory only if the benefits of operating the factory exceed the total costs, and the firm's decision will not only serve the firm's financial interest but also maximize total social welfare as well.

According to some, these ideas about cost internalization can be transferred directly to the realm of government decision-making and used as a justification for expansive takings liability. The argument starts from the premise that government "operates with an incentive structure similar to that of a similarly situated private enterprise." Richard A. Posner, Economic Analysis of the Law 58 (4th ed. 1992). The argument also posits that government regulatory actions create costs by imposing economic burdens on certain property owners. Liability under the Takings Clause, the argument continues, would "prevent[ ] the government from overusing . . . [its regulatory] power." *Id.* In just the same way that a polluting firm's business decisions will tend to be economically efficient if the firm internalizes the external costs of its operations, so too, according to this argument, government decisions would be economically efficient if the government were forced to internalize the costs of its regulatory activities through takings compensation awards. *See also* William A. Fischel & Perry Shapiro, "Takings, Insurance, and Michelman: Comments on the Economic Interpretations of 'Just Compensation' Law," 17 *J. of Legal Studies* 269, 270 (1992) (arguing that expansive takings liability would serve to "disciplin[e] the power of the state, which would otherwise overexpand unless made to pay for the resources that it consumes").

Contrary to this viewpoint, and as a number of scholars have demonstrated, extensive assessments of financial liability against the government under the Takings Clause will not necessarily increase total social welfare. In fact, expansive takings liability could well lead to net declines in total social welfare.

First, as a threshold matter, government functions very differently from a private firm and therefore cannot be expected to internalize "costs" in the same way. At the most basic level, when the government is sued for a taking it is not government's own money that is at stake, it is the taxpayers' money. A taking award ultimately involves a transfer payment from taxpayers to condemnees. Because the government's own money is not at risk, it is implausible that government would respond to financial liability in the same fashion as a private firm.

Taxpayer liabilities surely have consequences for government-decision-makers, but the influence of such liabilities is largely indeterminate. Unlike shareholders in a private firm who share a uniform pecuniary interest in the firm's affairs, the interests of citizens within a particular governmental jurisdiction are far more heterogeneous. Government officials do not automatically reflect the interests of their constituents, and in fact the interests of government officials may diverge significantly from those of their constituents. Given the relatively modest stake that most citizens have in the outcome of most government decisions, constituents face major obstacles in accurately monitoring their representatives' actions. For all these reasons, the likely effects of liability depend upon its visibility, the impact of the liability on different interest groups, the other issues on

the voters' agendas, and so on. *See generally* Daryl J. Levinson, "Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs," 67 *U.Chi. L. Rev.* 345, 355-57 (2000).

For example, if a takings judgment were paid in a low visibility fashion, without any direct repercussions for the responsible official's budget or status, the consequences of cost internalization might be modest. On the other hand, if the judgment required an official to lay off staff or created a major budget shortfall,[5] cost internalization could force government officials to err radically in the direction of avoiding takings liability.

Second, and most importantly for present purposes, the argument for extensive takings liability based on cost-internalization suffers from a fatal asymmetry. As discussed, the cost internalization argument proceeds on the assumption that the costs of government action have to be monetized and internalized in order to influence government decision-making. But the benefits of government action represent the other side of the economic equation. Government produces a variety of benefits through regulation, from a safe food supply, to non-polluted air and water, to public safety. If the costs of regulatory programs have to be internalized through monetary payments, as the advocates of an expansive reading of the Takings Clause assert, then the benefits of regulatory programs would have to be internalized in monetary terms as well

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[5] *See, e.g.*, Louise K. Ahern, "Novi May Rethink Future," The Detroit News (May 23, 2000) (describing how a $27 million takings judgment against a municipality forced cancellation of plans to build a new town library).

in order to create balanced incentives. Otherwise, the government calculus would be consistently skewed in favor of minimizing costs and government decision-making would tend to produce inefficient outcomes.

The reality, of course, is that the benefits of government regulatory action generally are not internalized by government. Furthermore, it is difficult as a practical matter to see how internalization could be accomplished on a broad scale. Thus, a broad takings liability rule would inevitably result only in internalization of costs and would tend to foster government decision-making that does not maximize total social welfare.

The relevance of this analysis in this case is straightforward. One may assume for the sake of argument that prohibiting development of coastal marshes maximizes total social welfare in Rhode Island by, among other things, avoiding harms to economically valuable commercial fisheries and by avoiding pollution that would cause harm to tourism, real estate, and other businesses. If the Takings Clause were interpreted to require compensation in these circumstances, the State would obviously incur a financial penalty for not issuing a permit allowing destruction of this environmentally sensitive site. On the other hand, the State cannot realize the benefits of restricting development in the same fashion. Thus, assuming the Rhode Island Coastal Council functioned like a private firm (a heroic assumption for all the reasons explained above), the asymmetry inherent in an expansive theory of regulatory takings would encourage the State to authorize the destruction of coastal wetlands despite the fact that that decision would not be optimal from an economic standpoint.

One potential response is that the political benefits to government officials of rejecting a development proposal may counter-balance the potential chilling effects of takings liability. In some cases, of course, that may be true. But if pro-regulatory political forces can exert political pressure on government officials from one side, it is equally true that opponents of regulation can exert political pressure in the opposite direction. Elected representatives are routinely called upon to weigh the costs and benefits of different decisions, both in political terms and in broader social and economic terms.

If anything, property owners are likely to be a better-organized and more vocal political force than the general public when it comes to regulatory policies. The numerous members of the general public that share in the benefits of regulatory protections are likely to be difficult to organize into an effective political force. *See generally* Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (1971 ed.). By contrast, regulated property owners with relatively large financial stakes in regulatory policies can generally be organized to exert effective political pressure with relative ease. Even if they are outnumbered in political terms or are political outsiders, property owners have other opportunities and significant incentives to influence the outcome of political debates affecting their interests. *See* Vicki Been, " 'Exit' as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine," 91 *Colum. L. Rev.* 473 (1991). Accordingly, internalization of regulatory costs while regulatory benefits remain external cannot be

justified on the theory that this asymmetry is counterbalanced by the relative political strength of the beneficiaries of regulation. The opposite is as likely, if not more likely, to be true.[6]

Finally, the government deterrence argument ignores the significant transaction and other costs of administering an expansive regulatory takings scheme. Broad government takings liability would greatly complicate and increase the cost of existing administrative processes, require significant new investments in calculating

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[6] In *San Diego Gas & Electric v. San Diego*, 450 U.S. 621, 661 n. 26 (1981), Justice Brennan posed the rhetorical question, "If a policeman must know Constitution, why not a planner?" This statement indicates some sympathy for the government-deterrence rationale. However, Justice Brennan's remark appeared in a case alleging that a regulation eliminated the "entire beneficial use of the property." *Id.* at 626. Thus, it cannot be interpreted as necessarily supportive of compensation for regulatory takings under a more expansive theory. In addition, the comparison to a police officer actually tends to support a narrow reading of the Takings Clause. When a municipality, for example, is sued for alleged police misconduct, the government is liable only if the misconduct represents "the government's policy or custom," *Monell v. Department of Social Services*, 436 U.S. 658, 694 (1978). This defense accords municipal officials significant latitude in carrying out their duties and allows them to continue to do their jobs effectively. *Cf. Scheuer v. Rhodes*, 416 U.S. 232, 240 (1974). By contrast, in a takings suit against a municipality the official "policy or custom" requirement will provide little protection because there generally will be no question that the regulatory decision at issue represents government policy. Thus, in contrast to the example of a constitutional tort suit based on alleged police misconduct, judicial interpretation of the Takings Clause has to do all of the work of preserving government officials' ability to govern effectively.

compensation amounts, and require new governmental efforts to increase revenues or to reallocate existing budget resources to meet the compensation requirements, especially if the full benefits of regulation cannot be internalized for the reasons stated above. Expansive takings liability would also exact other costs by requiring the public to drop or defer other socially beneficial actions that available public funding could no longer support.

B. Other Efficiency Rationales.

Aside from the questionable and quite possibly counter-productive government-deterrence argument for takings liability, takings advocates have advanced two other efficiency arguments based on the incentives that compensation would create for individual firms. Neither argument is persuasive. Furthermore, upon careful analysis, these arguments suggest that expansive compensation for regulatory takings could create incentives for firms to take economically inefficient actions.

The first argument is that the absence of compensation would cause inefficient under-investment in economically productive resources. *See, e.g.*, Lawrence Berger, "A Policy Analysis of the Taking Problem," 49 New York Univ. L. Rev. 165, 195-206 (1984). According to this view, property owners would rationally discount the value of an investment by the risk of an uncompensated taking and therefore would invest at a sub-optimal level. This reduction in investment, the argument proceeds, would reduce total social welfare.

This argument is not convincing because it ignores the fact that this reduced investment is not necessarily sub-optimal and therefore should not necessarily be

counted as an efficiency cost. One may reasonably assume, at a minimum, that many new regulations are adopted for good and valuable purposes. If owners lack an incentive to invest in property uses that may in the future be determined to be sub-optimal, that result is arguably beneficial.

Furthermore, extensive taxpayer-funded takings awards would likely lead to overinvestment because they would cause owners to disregard the risk that government regulations might be enacted to shift property to a higher economic use. Instead of solving an under investment problem, the availability of compensation would tend to create what economists call a "moral hazard" of overinvestment. As stated by Professor Darryl Levinson, "just as the generous disaster relief for flood victims encourages over-building on flood plains, and International Monetary Fund bailouts encourage too much borrowing and fiscal irresponsibility by debtor nations, full indemnification for takings condemnees encourages overinvestment in property." Daryl J. Levinson, "Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs," 67 *U.Chi. L. Rev.* 345, 390 (2000).

Another, related argument in favor of extensive takings liability is that compensation under the Takings Clause would be analogous to and would serve the same economically beneficial function as private insurance. *See, e.g.*, Lawrence Blume & Daniel L. Rubinfeld, "Compensation for Takings: An Economic Analysis," 72 *California L. Rev.* 569 (1984). According to this view, the insured risk is the risk that the government may enact a regulation that would adversely affect a property owner. The insurance

payment is the award of compensation from the government. According to standard economic analysis, private insurance promotes economically valuable activity by allowing risk-averse firms to spread the risks of their investments. Similarly, according to this argument, expansive takings compensation should promote economically efficient behavior by causing risk-averse investors to make productive investments they would otherwise shy away from making. The opportunity to spread risk created by the availability of compensation from the government, according to this view, increases total social welfare.

This theory begs the question why the insurance cannot be supplied by the private market. Taxpayer-funded compensation would, in effect, relieve the beneficiaries of the insurance, i.e., owners potentially subject to regulation, of the obligation to pay for it and would transfer the burden of paying for the insurance to taxpayers generally, many of whom would not logically participate in this kind of insurance program voluntarily. Compelling non-property owners to subsidize an insurance program for property owners would undoubtedly effect an arbitrary and regressive wealth transfer to owners. Furthermore, it is doubtful that an across-the-board compensation scheme makes economic sense. Insurance provides economic benefits when it is made available to risk-averse investors, but not all investors are risk averse and some investors, particularly large corporations, are capable of minimizing the impact of risk by acquiring a portfolio of investments. *See generally* Daniel A. Farber, "Public Choice and Just Compensation," 9 *Const. Comment* 279 (1992).

In sum, neither of these alternative efficiency arguments for an expansive theory of regulatory takings is persuasive.

CONCLUSION

For the foregoing reasons, the Court should affirm the judgment of the Rhode Island Supreme Court.

Respectfully submitted,

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APPENDIX

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